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In the Supreme Court of the United States

OCTOBER TERM, 1992

JOHN J. WATERS AND JEANNE M. WATERS,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether petitioner is "at risk" with respect to the debt he incurred in a circular sale-leaseback of computer equipment and is therefore allowed to take deductions in excess of his cash investment in the transaction under Section 465 of the Internal Revenue Code, 26 U.S.C. 465.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-19a) is reported at 978 F.2d 1310. The opinion of the Tax Court (Pet. App. 20a-39a) is unofficially reported at 62 T.C.M. (CCH) 778.

JURISDICTION

The judgment of the court of appeals was entered on October 21, 1992. The petition for a writ of certiorari was filed on January 7, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1981, Equitable Financial Management, Inc., an equipment leasing company, purchased certain computer equipment from a manufacturer. Equitable financed the purchase price by borrowing funds from a bank on a nonrecourse basis. Equitable leased the equipment to Duquesne Light Company. The lease rental payments "effectively matched Equitable's payments on the bank loan." Pet. App. 4a-5a.

In August 1982, Equitable sold the equipment to Cooper Leasing Corporation, Inc. Equitable and Cooper Leasing were owned and controlled by the same two individuals. The sale price for the equipment was $298,000, which was paid with $1,000 in cash and a promissory note in the amount of $297,000. Pet. App. 5a, 23a-24a.

Simultaneously with the sale of the equipment to Cooper Leasing, Cooper Leasing resold the equipment to petitioner John J. Waters* and an associate, Gerald Moffatt, as joint tenants, for a stated purchase price of $300,000. Petitioner and Moffatt each made a cash payment of $1,500 and executed separate, recourse promissory notes in the amount of $148,500. Payments on each of the notes were to be made under terms that were identical to the payment obligations of Cooper Leasing to Equitable. Pet. App. 6a, 24a-25a.

Simultaneously with these transactions, petitioner and Moffatt leased the computer equipment back to Equitable for a fixed term of eight years and four

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* Petitioner Jeanne M. Waters is a party because she filed joint income tax returns with her husband for the years in issue.

months. Equitable agreed to make monthly lease payments to petitioner and Moffatt that essentially matched (i) the monthly note payments due from petitioner and Moffatt to Cooper Leasing and (ii) the monthly note payments due from Cooper Leasing to Equitable. (Pet. App. 6a, 25a-26a). The lease also contained a provision under which Equitable indemnified petitioner and Moffatt for any loss that they might incur "by reason of any breach by [Equitable] of any of the representations by, or obligations of, [Equitable] contained in th[e] Lease." Pet. App. 6a, 27a.

Petitioner, Moffatt, and Cooper Leasing also entered into a management agreement, under which Cooper Leasing was to collect from Equitable the monthly lease payments due from Equitable to petitioner and Moffatt. From those payments, Cooper Leasing was to credit petitioner's and Moffatt's monthly obligations under their notes to Cooper Leasing. Cooper Leasing was then to transfer the payments *back* to Equitable in payment of Cooper Leasing's debt to Equitable. Pet. App. 7a.

2. Petitioner claimed deductions relating to the equipment leasing transaction on his income tax returns for the years 1982, 1983, 1984, and 1985. Pet. App. 8a-9a. On audit, the Commissioner disallowed the claimed deductions because petitioner had none of the burdens of ownership of the equipment, the transaction was not conducted for profit, and the transaction lacked economic substance. The Commissioner determined, in the alternative, that the amounts of petitioner's deductions were limited by Section 465 of the Internal Revenue Code, which generally provides that a taxpayer may deduct a loss

from an activity only to the extent that he is "at risk" for that activity. Pet. App. 9a. Section 465(d) defines "loss," for purposes of the Section, as the excess of allowable deductions allocable to an activity over the income from such activity.

3. Petitioner sought review of the resulting deficiencies in the Tax Court. The Tax Court determined that the transaction was not a sham, that petitioner had a profit motive, and that he had acquired ownership of the equipment. Pet. App. 35a-38a. The Tax Court further determined, however, that petitioner was not "at risk" (within the meaning of Section 465) with respect to the purported debt obligation to Cooper Leasing because that obligation was "protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." 26 U.S.C. 465(b)(4). The Tax Court determined that the nonrecourse underlying bank debt, the circular, matching debt obligations, and the indemnification provided by Equitable to petitioner constituted an "other similar arrangement" under Section 465(b)(4) of the Code by which petitioner was effectively protected against loss in connection with his debt (Pet. App. 29a-30a).

4. The court of appeals affirmed (Pet. App. 1a-19a). The court held that a taxpayer is not "at risk" for purposes of Section 465 when a transaction is structured to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable (Pet. App. 15a). The court concluded that the circular nature of the arrangements between taxpayer, Cooper Leasing, and Equitable, coupled with the virtual identity of composition and control of Equitable and Cooper

Leasing, the matching payment obligations, and the nonrecourse underlying bank debt effectively immunized taxpayer from any loss. *Id.* at 15a-16a. The court rejected petitioner's argument that a loss-limiting arrangement within the meaning of Section 465(b)(4)—which lists various arrangements that remove a taxpayer from "risk" (see 26 U.S.C. 465(b)(4))—encompasses only agreements that protect a taxpayer from loss *after* the losses have occurred. The court noted that the phrase used in the statute was "similar arrangements" rather than "agreements," and that the "arrangements" contemplated by the statute "may be 'similar' not only to 'guarantees' and 'stop loss agreements,' but also to 'nonrecourse financing,' ordinarily a *prearrangement* to protect against loss." Pet. App. 14a.

The court also rejected petitioner's contention that the "worst-case scenario," rather than economic reality, must be considered in applying Section 465(b)(4). The court noted that the legislative history reflects that the insolvency or bankruptcy of a party to a loss-limiting arrangement is not material under an at risk analysis. Pet. App. 18a (quoting S. Rep. No. 938, 94th Cong., 2d Sess. 50 n.6 (1976)). Moreover, the overall structure of the statute, which focuses on "risk" and which defers, rather than permanently disallows, losses, supports an interpretation of the statute that focuses on economic realities. Pet. App. 17a-18a. The court concluded that, because at the close of the years in issue petitioner did not face any realistic possibility of loss, the Tax Court properly determined that he was not "at risk" within the meaning of Section 465 with respect to his obligations to Cooper Leasing (Pet. App. 18a-19a).

ARGUMENT

The decision of the court of appeals is correct. Although the Sixth Circuit reached a contrary decision in *Emershaw* v. *Commissioner*, 949 F.2d 841 (1991), there is no need for this conflict to be resolved because the importance of "at risk" analysis under Section 465 has been substantially diminished by subsequent congressional enactment.

1. In 1976, Congress added Section 465 to the Internal Revenue Code to combat increasing abuse of tax benefits derived from the use of nonrecourse financing. See S. Rep. No. 938, 94th Cong., 2d Sess. 45-51 (1976). Congress determined that the use of nonrecourse financing and other risk limiting devices presented significant tax abuses, for they permitted taxpayers to deduct amounts in excess of their bona fide investment at risk in the transaction. See *id.* at 47.

In order to prevent taxpayers engaged in certain activities from deducting losses in excess of their actual economic investment in the activity, Section 465(a)(1) provides that a taxpayer engaged in an activity to which Section 465 applies may deduct a loss from that activity "only to the extent of the aggregate amount with respect to which the taxpayer is at risk * * * for such activity at the close of the taxable year." 26 U.S.C. 465(a)(1). A taxpayer's amount "at risk" with respect to an activity is generally the amount that he "could actually lose from th[e] activity." H.R. Rep. No. 1445, 95th Cong., 2d Sess. 67 (1978). A taxpayer is generally considered "at risk" to the extent of the cash and the adjusted basis of property contributed to the activity (26

U.S.C. 465(b)(2)(A)), as well as any amounts borrowed for use in the activity to the extent that the taxpayer "is personally liable for the repayment of such amounts." 26 U.S.C. 465(b)(2)(A). See S. Rep. No. 938, *supra*, at 49. Under Section 465(b)(4) of the Code, however, a taxpayer is not considered at risk with respect to "amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." 26 U.S.C. 465(b)(4). See S. Rep. No. 938, *supra*, at 49-50.

The Tax Court (Pet. App. 29a-30a) and the court of appeals (*id.* at 12a-15a) correctly determined in this case that Section 465(b)(4) applies to *any* mechanism or arrangement that has the effect of immunizing the taxpayer from economic losses from the venture. Because of the circular, offsetting sales and leases in the present case—under which Equitable was both the initial obligee (on the note from Cooper Leasing) and the ultimate obligor (on the lease from petitioner and Moffatt)—the financial viability of the transaction was not in any manner dependent on Equitable's rental payments to petitioner. Indeed, because of Equitable's dual role—which resulted from a series of interrelated transactions that occurred on the same day—Equitable, Cooper Leasing and taxpayer were all able to satisfy their circular monthly obligations through offsetting bookkeeping entries. Because no cash needed to change hands, Equitable, Cooper Leasing, and petitioner could continue to satisfy their respective monthly obligations by means of these offsetting obligations even if the underlying lease to Duquesne were defaulted. The circular, offsetting nature of these obligations, the identity of Equitable and Cooper Leasing with respect to

composition and control, Equitable's agreement to indemnify the taxpayer, and the underlying non-recourse bank debt all effectively removed any realistic possibility that petitioner would suffer an economic loss from the transaction. Pet. App. 15a-16a.

Three other courts of appeals—the Ninth Circuit in *American Principals Leasing Corp.* v. *United States*, 904 F.2d 477 (1990), the Eighth Circuit in *Moser* v. *Commissioner*, 914 F.2d 1040 (1990), and the Eleventh Circuit in *Young* v. *Commissioner*, 926 F.2d 1083 (1991)—have reached the same conclusion reached by the Second Circuit in this case. Those courts have also held that Section 465(b)(4) applies to any arrangement that effectively immunizes the taxpayer from incurring loss. In those cases, the courts were faced with three-party circular sales and leasebacks of computer equipment that were essentially the same as the transaction involved in the present case. All of these courts concluded that the taxpayers involved were not "at risk" because there was no realistic possibility that the taxpayers would be required to satisfy their notes. In reaching this conclusion, each of the courts emphasized that the circular, offsetting nature of the obligations ensured that the taxpayers never would be called upon to satisfy personally their respective obligations. See *Young* v. *Commissioner*, 926 F.2d at 1089; *American Principals Leasing Corp.* v. *United States*, 904 F.2d at 483; *Moser* v. *Commissioner*, 914 at 1049. See also *Thornock* v. *Commissioner*, 94 T.C. 439 (1990).

2. Petitioner correctly notes (Pet. 13-15) that in *Emershaw* v. *Commissioner*, 949 F.2d 841 (1991), the Sixth Circuit interpreted Section 465(b)(4) to deny

"at risk" treatment for a transaction only when a "collateral agreement" has been made with a third party, who is a stranger to the transaction, that protects the taxpayer against loss *after* the losses have occurred. See *Emershaw* v. *Commissioner*, 949 F.2d at 849. The court of appeals correctly concluded in this case, however, that that interpretation of Section 465(b)(4) is contradicted by the plain language of the statute, which refers to "nonrecourse financing" and other "similar arrangements" (26 U.S.C. 465(b)(4)). As the court of appeals observed in this case, "nonrecourse financing" is "ordinarily a *prearrangement* to protect against loss." Pet. App. 14a.

The Sixth Circuit's interpretation of the statute is also contrary to the fundamental premise of Section 465, which is that a taxpayer's deductions should be limited to the investment for which he is "at risk" (26 U.S.C. 465(a)). The object of the statute is "[t]o prevent a situation where the taxpayer may deduct a loss in excess of his economic investment." S. Rep. No. 938, *supra*, at 48. The Sixth Circuit erred in *Emershaw* by placing emphasis on the statement in the Senate Report that "an investor is not 'at risk' if he arranges to receive insurance or other compensation for an economic loss after the loss is sustained, or if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person" (S. Rep. No. 938, *supra*, at 49). See 949 F.2d at 848-849. As the court of appeals stated in the present case, "[w]hile the Senate Report outlines some arrangements that fall within § 465(b)(4), it does not directly address the language of that provision or purport to provide an exhaustive description of its coverage." Pet. App. 14a.

Petitioner also contends (Pet. 9-13) that the court of appeals erred in disregarding the "worst-case scenario," *i.e.*, the potential insolvency or bankruptcy of Equitable. The Senate Report, however, indicates that the possibility that the party protecting the taxpayer against loss "will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not to be material unless and until" the time such event occurs. S. Rep. No. 938, *supra*, at 50 n.6. For this reason, courts have correctly rejected the suggestion that the "worst-case scenario," instead of economic reality, should be the guide in determining whether the taxpayer is "at risk" for purposes of Section 465. See *Moser* v. *Commissioner*, 914 F.2d at 1049; *American Principals Leasing Corp.* v. *United States*, 904 F.2d at 482.

3. The importance of the question presented in this case has been substantially diminished by subsequent legislation. In 1986, Congress added Section 469 to the Internal Revenue Code to eliminate the benefits of many traditional tax shelters. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2233; S. Rep. No. 313, 99th Cong., 2d Sess. 713-718 (1986). Effective for tax years beginning after December 31, 1986, Section 469 generally provides that losses from a "passive" trade or business activity are deductible only against income from that or another passive activity, and cannot be deducted against other income, such as salary, interest, dividends, and active business income. See S. Rep. No. 313, *supra*, at 718-719, 722; 26 U.S.C. 469(a). A "passive activity" is an activity "in which the taxpayer does not materially participate" and which involves the conduct of a trade or business. 26 U.S.C. 469(c)(1). While Section 465

was designed to combat one of the significant features of the traditional tax shelter, the passive loss limitations of Section 469 respond directly to the sheltering of income and prevent a taxpayer from reducing taxes on income from one source with losses and excess credits from another source.

The Section 469 passive loss limitations are broader in scope than those of Section 465 and have effectively displaced analysis under that Section. Even if a taxpayer is considered to be "at risk" with respect to an investment, a loss may only be claimed to the extent that it is allowed by Section 469. See Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986*, at 223 & n.17 (1987); 26 C.F.R. 1.469-2T(d)(6). For tax years beginning after 1986, the passive loss limitations thus bar deductions of the type involved in the present case *regardless* of whether the taxpayer is "at risk." The question addressed in this case, and in *Emershaw*, would thus be inconsequential with respect to an identical transaction entered into after December 31, 1986.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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